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How to Finance the War

by

EDWIN R. A. SELIGMAN
McVickar Professor of Political Economy
Columbia University

and

ROBERT MURRAY HAIG
Assistant Professor of Economics
Columbia University

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HOW TO FINANCE THE WAR

Making war is easily the most expensive function of government. Always costly, in modern times it has come to involve truly astounding expenditures. When, as is now the case, the entire accumulated wealth and productive power of a nation join with its man power to match strength with the adversary, the skill used in raising the necessary funds is of paramount importance. Having decided to enter the conflict, the United States government stands in immediate need of billions of dollars. How many billions will be required before the war is brought to its end cannot be foretold, but our resources may be strained to their capacity. A number of plans have been proposed for meeting the situation, each different in its fiscal and economic consequences. The problem is to determine upon the particular program which will best distribute the burden in accordance with ability to bear it, and which will produce the huge sums needed with the least impairment of our resources. To cripple ourselves at the outset of the war with a faulty financial plan might have disastrous consequences. To adopt any but the wisest policy of finance would involve unnecessary waste and suffering.

There are good reasons why the best plan for financing this particular war differs radically from the plans which we have used in the past. Political problems, for example, which in other days have been powerful factors in moulding fiscal policies are fortunately of negligible importance. Moreover, the

economic situation is infinitely more favorable than any which has existed heretofore. We have not only greater resources, but resources of a different type upon which to draw. In other wars, our traditional policy has usually been to tax ourselves only when no one would lend us the money. In the absence of political and economic exigencies, a very different policy may be adopted. Finally there have been radical social changes since our previous wars which will affect our methods of finance. Types of taxes and forms of bond issues which were considered unobjectionable not long ago will not now measure up to the ideas of justice established by a democracy which has become progressively more enlightened and intelligent.

The problem of financing the war resolves itself into three distinct parts, each of which will be treated in a separate section. The first is concerned with the general question of loans versus taxes. To what extent shall the expenses of the war be met by borrowed money and to what extent by the proceeds from taxation? The second section discusses the kind of indebtedness to be incurred and the third the methods of taxation to be employed.

However, before these problems can be discussed with any degree of definiteness, it is necessary to make some general assumptions regarding the probable length of the war and the part we are to play in it. For the magnitude of the sums to be raised is of very great importance in connection with the probable strain on the revenue system through increased tax-

ation, and in connection with the general economic effects of an appeal to credit.

There is every indication that the policy of the United States in this war will be one of enthusiastic coöperation with our Allies. To the extent that we are at present prepared to furnish military assistance, that will be given; far-reaching measures will be adopted to train a large army; and economic aid will be extended. But there appears to be a wide-spread belief that the war will end very quickly, perhaps before our power can be brought to bear to any considerable extent. If this view is correct, the financial problem will, of course, be insignificant. But it is the part of prudence to prepare for the alternative issue. In this, we may well learn a lesson from the other belligerents. Although Lord Kitchener did predict a three-year war, the early fiscal policies of the European nations were predicated on a much shorter period; and it was only after a lapse of a considerable time that plans for financing a protracted contest were adopted. Lord Kitchener's three-year period has almost expired and yet even now it cannot be definitely asserted that the end of the war is in sight. There appears to be no sound basis of known facts for the belief that the Central Powers are on the verge of collapse. What the true military and political situation may be in Germany, it is impossible to judge with accuracy. But he is an optimist indeed who would depend upon an economic or financial breakdown to bring about the cessation of hostilities within a short time.

Assuming that we are to enter into this war in a whole-hearted manner and assuming, as seems prudent and reasonable, that the war will last long enough for us to bring our forces into action, how much money will be needed? This question, of course, can be answered only by the roughest of estimates. With no experience of our own to guide us, the English experience forms, perhaps, our best foundation for a guess. Bonar Law has recently stated that the total expenditures of England for the fiscal year just ended will be about £2,140,000,000 or approximately ten and one-half billions of dollars. It is not probable that our full share in the war will be less than this. Doubtless, our army at first will be considerably smaller than that of Great Britain but it must be remembered that the cost of our military forces, particularly the pay of our soldiers and sailors, is larger than is the case abroad. Before the war, the military and naval expenditures of the United States, in spite of the insignificant size of the army, were approximately as great as those of Germany. An expeditionary force to Europe would involve outlays of enormous extent. Finally, we shall doubtless be immediately called upon to make considerable advances to our Allies. All in all, it would seem that our war expenses might reasonably be expected to approximate ten billions a year. How can this sum best be secured?

I. LOANS VERSUS TAXES

There is in this country no 'war chest' upon which to draw in an emergency; there are no profits from

enterprises conducted by the government; and there will probably be no indemnities wrung from a conquered people. It follows that the money must be collected by taxation or be borrowed. It is barely conceivable that the total sum might be borrowed and taxation avoided entirely for the present. On the other hand, it is being seriously urged by many well-informed persons that the entire cost of the war be met by current taxes. There are a number of reasons why the wisest course lies between these extremes.

Our own history is perhaps most useful for the purpose of pointing out what to avoid rather than what to adopt in war finance but it is, nevertheless, of importance to recall that the policy of meeting all war expenses by taxation is entirely new in the United States. Indeed, the question here has rather been whether taxes could be made sufficiently high to meet merely the interest charges on the money borrowed without any allowance even for amortization. Thus, Gallatin's original war budget, at the time of the struggle with England, contemplated a tax levy for interest only. But the taxes actually imposed proved insufficient even for this purpose, with the result that in 1814 Dallas had to be summoned to extricate the country from a condition of bankruptcy —an end which he accomplished through a more vigorous policy of taxation. Again, the financial history of our Civil War is primarily one of loans, forced or voluntary, rather than one of taxes. During 1862 and 1863, when the proceeds from loans were

about $300,000,000, the increase in taxes over those of peace times scarcely sufficed to pay the interest on the new debt. During the first year of the conflict, they were entirely inadequate for this purpose. It was not until after 1864 that the taxes made any substantial contribution to war expenses. Finally, in the Spanish war, a $200,000,000 loan was the foundation stone of the financial plan, the sole increases in taxation being new internal revenue duties which yielded only about $25,000,000 of additional revenue in 1898 and $125,000,000 in 1899.

It would be a novelty not only to American finance to levy war taxes in larger amount than required for interest on the debt, but it would be almost as much a novelty in European countries. Germany, during the present war, refrained for a long time from imposing any war taxes at all, and the recent additions to the imperial tax budget are intended primarily to defray the interest on the huge loans. The policies of England and France have been essentially the same except that England began to tax for interest purposes somewhat earlier than the others. The total war expenditures of England up to April, 1917, has been stated by Mr. Bonar Law to be about £4,200,000,000 and the total debt to be £3,900,000,000. This debt of approximately $20,000,000,000 is expected to increase to $30,000,000,000 by the end of the present fiscal year, and will then entail an interest charge of about $1,500,000,000 annually. The new English war taxes yield only a relatively slight amount over this interest charge.

It is not to be inferred, however, that because the proposal to pay for the war by current taxation is strange in the history of war finance, it is therefore undesirable. On the contrary, it is a proposal which has many features which decidedly commend it for adoption. Our past practice certainly cannot be defended as a perfect model for present action, and we are in such a strong position economically as compared with the other nations at war that we may well be able to withstand a more rigorous financial program than those they have used. It should be realized, however, that any taxation beyond that necessary for interest payment is unusual and is open to the uncertainties which arise when a departure is made from established practice.

It seems doubtful whether the adherents of the 'taxation only' policy realize the full practical import of their proposal. To raise the carrying charges alone on the huge sums which will be used will mean taxation of staggering weight. If we are to count on an expenditure of not far from ten billions the first year and a similar sum for a possible second year of war, it would be necessary, assuming that all current war expenses are to be defrayed by loans made on a five per cent. basis, to levy additional taxes to the extent of about $500,000,000 for the first year and perhaps one billion for the second year of war. This much at least, everyone will agree, should be covered by current taxation. The real question is: How much more shall be raised at once by this method for amortization purposes and for payment of war

expenses directly? Let us examine some of the arguments advanced in connection with the controversy of loans versus taxation.

Among the arguments in support of the taxation policy is one which holds that a resort to loans would lead to an immense inflation in prices. Although some merit undoubtedly attaches to this view, its importance can easily be exaggerated. Whether public borrowing will lead to an inflation of prices depends largely on the conditions on which loans are contracted. If the subscriptions to the loan are defrayed by borrowing from the banks, such a result would undoubtedly ensue, at least to the extent that analogous subscriptions might not have been made to ordinary industrial enterprises. But if, on the contrary, there is a large loan fund in existence—if, in other words, the accumulated profits of recent years have not yet been invested, or if the subscriptions to the loan involve simply a change of investment from private enterprise to government service, there will be no such resort to credit and there will be no such inflation of prices. It is entirely probable that, as a result of our prodigious prosperity during the last year or two, a very large loan could be floated without an inordinate resort to banking credit.

A second argument takes the form of an attack upon the loan policy. Subscriptions to loans, it is maintained, will be made by the wealthier classes who will thereby fasten upon the community as a whole an incubus in the shape of the obligation to pay them interest for a long time. This argument, however,

presupposes that the tax burden, designed to defray the bond interest, will fall primarily on the poor. If, on the contrary, the general tax system is so adjusted as to recognize the principles of equality and ability-to-pay, the interest on the debt will be primarily defrayed by the very classes who subscribe to the bonds. If this be done, it is a matter of indifference whether the tax or the loan policy is adopted so far as the burden upon the poorer classes is concerned. The richer portion of the community will pay the bills either way. But it is a matter of great importance to them whether they are asked to pay in two years or in ten years. The interests of the poorer classes, moreover, may be very adversely affected if the taxation policy is made so severe as seriously to cripple industry in general.

There is still another argument—one which depends for much of its force upon the attractiveness of a phrase which seems to have originated in Australia. If we are to have conscription of men, we are told, we ought also to have conscription of wealth or conscription of income. But in the first place, is it accurate to classify and to contrast in this manner? Is it proposed to draft for personal service only the poor of purse? Will not the wealthy be called upon to make sacrifices of service? The proposal to permit able-bodied men of wealth to purchase exemption from military duty by surrender of their property would certainly not appeal to anyone. When war begins to reap its harvest, there will doubtless be a full measure of distress among the wealthy. More-

over, does not this argument appear to rest to some extent upon a desire to punish and to cause suffering? Paraphrased, it would read as follows: The poor will have to suffer by rendering personal service; let us make the rich suffer also by compelling them to surrender their incomes. There will be personal service rendered by both rich and poor, and if the war continues for a long time great suffering will ensue. The sacrifices of the poorer classes certainly must not be increased by the addition of heavy economic burdens. Wherever the expenditure of money will further the purposes of the war, will prevent suffering and save life, the money must be spent. The financial burden of this must indeed be borne by those who have a surplus, and there is every indication that they will accept the burden willingly. But instead of planning our war finance in a spirit of vindictive destructiveness, every effort should, on the contrary, be made to render this part of the war sacrifice as easy and convenient to bear as possible.

Moreover, several positive considerations may be urged against the extreme form of the 'conscription of wealth' argument. For instance, the raising of all war expenses by taxation is like the pay-as-you-go policy in peace times. The objection to defraying extraordinary capital expenditures out of taxation is that it causes this year's taxpayers to contribute an undue share for benefits accruing far in the future. Meeting all war expenses by taxation makes the taxpayers in one or two years bear the burden of benefits that ought to be distributed over a decade or two.

Again, the raising of such immense sums would involve an unendurable strain upon our tax machinery, particularly since a large part of the additional sums will have to come from income taxes. For it must be remembered that the great mass of American incomes is derived from agriculture, and that of all incomes, these are the most refractory. The only result of an attempt to 'confiscate' might be the complete breakdown of the tax system.

Finally, the adoption of the 'taxation only' policy would involve a very serious diminution of the incomes which at the present time are largely drawn upon for the support of educational, charitable and philanthropic enterprises. Moreover, this source of support would be dried up precisely at the time when the need would be greatest. In calculating the advantages of the policy, therefore, it is necessary to consider the fact that the state would be compelled to assume a number of functions now performed by private individuals, so that not only would some of the gain be more apparent than real, but there would also be, in all probability, a considerable loss entailed by the difficult and hasty transition from private to public activities.

For the reasons made clear in the foregoing discussion, it appears that the 'conscription of wealth' plan in its extreme form would not be feasible. It is entirely practicable, however, and it is on the whole very desirable in our present situation to levy taxes far in excess of what has been our custom in past wars. In addition to money to pay interest on the loans,

there should be raised by taxation a sum intended to secure a speedy amortization of the debt. If, as we shall see later, the debt ought to be thrown into a form which will insure its disappearance in not more than ten or twenty years, the amortization quota should amount to five or ten per cent. annually. On the assumption that a two-year war debt would amount to twenty billions, there would be needed for the amortization quota from one to two billions a year. The fiscal conclusion, therefore, would be that we should raise by new taxation for the first year of the war at least one and one-half billions of dollars (half a billion for interest, one billion amortization), and during the second year three billions (one billion interest and two billions for amortization). When one recollects that the total federal revenue from taxation in 1915 was $625,000,000, he will appreciate what a stupendous program this implies. It involves an increase in taxation far in excess of anything that has been known in American history and considerably more than what has been attempted in Europe. To accomplish this successfully will be a magnificent triumph for our revenue system. We should raise by taxation what we can without stifling enterprise and causing intolerable discontent, but if we spend in this war only what we can secure in this manner, without resort to loans, our participation will be insignificant and ineffective.

II. LOANS

The arguments of the advocates of 'taxation only' will probably not receive substantial support at

Washington. Indeed, the first loan bill has already been presented to Congress. In this bill, there are four chief points of interest:

(1) the amount of the issue;
(2) the rate of interest;
(3) the term of the loan and provisions for repayment; and
(4) the problem of tax exemption.

Each of these points will be briefly discussed.

1. The bill provides for an issue of $7,000,000,000 of which $5,000,000,000 is in bonds. If our calculations, based on the experience of the European countries, are correct, the present issue will not suffice for our needs for the first year. It is indeed the largest loan that has ever been issued by any country and it will be a strong test of the ingenuity of our officials and the loyal readiness of our people. It is, perhaps, as large as can conveniently be handled at one time; but an additional loan is to be expected before the lapse of many months.

2. The rate of interest in the bonds is fixed in the bill at three and one-half per cent. This differs radically from the proposal made above that the loan be made on a five per cent. basis. In the first place, however, the bonds are exempt from taxation. Were the bonds to be subject to taxation, the rate of interest would have to be at least four per cent. or possibly four and one-half per cent., if the bonds were to sell at par. In the estimates made above no allowance is made for the exemption of the bonds from taxation

for the obvious reason that, in the main, what is saved by the government in the lower rate of interest due to the tax-free provision will again be lost by the government through the diminished yield of the income tax. Furthermore, it must be remembered that this is only the first installment of what is probably to become a gigantic war debt, and with every future issue on a large scale the rate of interest will doubtless increase. There is not much reason to expect that in a short time our credit will stand very much higher than that of the other warring countries, or that investments in government paper will be possible at a much lower rate of interest than in secure investments of a private character. The destruction of capital, which is going on at such an enormous rate, will tend to bring about a gradual rise in interest rates. It therefore still remains a conservative estimate that the loans of the United States will be issued on an average of a five per cent. basis.

3. The terms on which the loan is to be issued are not fixed in the bill, but are left entirely to the discretion of the authorities. This is true, even of the length of the loan. It is obvious that the longer the loan, the more favorable the conditions under which it can be marketed; but it is true also that long term bonds, say for thirty or fifty years, are of questionable advisability in other respects. In the case of countries which have no objection to perpetual debts, such bonds may be defensible but there have always been and are today valid objections to perpetual debts in the United States. Since every generation may be

expected to have troubles of its own, it is clearly a part of wisdom for any nation, which can possibly afford to do so, to pay off its debt within the generation which contracted it. Our experiences, moreover, with the bonds which were issued during the great refunding operations after the Civil War, even though their length was only thirty years, was sufficiently disheartening. Although there was a large balance in the Treasury during the '80's, we were unable to pay off the debt except by the very costly method of buying long-term four per cent. bonds in the market, often at a premium of from twenty-eight to thirty per cent. The government should profit from this experience, and should issue bonds to run for not more than ten years or, at the outside, twenty years.

Still more important, however, is the arrangement for repayment. Most of the loans issued in this country have been so-called 'straight' bonds, all of which mature at the same time, with a more or less adequate sinking-fund system. The sinking fund provisions in our loans of the Civil War have, as is well known, never been considered of a binding character. They have been rather bookkeeping devices and the government has paid off from year to year either more or less than the nominal sinking-fund requirement, as the exigencies of the time demanded. In our state finance, the abuses of sinking funds have been very notorious of recent years and have led, in not a few states, to the introduction of the so-called serial bond system whereby a certain proportion of the issue is retired annually. Almost

no attention has been given in this country, however, to other forms of bond issues which provide for retirement in either regular or irregular instalments. A study of the history of public credit will show that there is a great variety of issues possible, and that many of the methods practised, especially in the local finance of some of the European countries, are well worth consideration by our government. However that may be, one conclusion is certain, namely, that from the very time of issue adequate provision should be made for an annual amortization quota so arranged that at the expiration of the life of the loan, the entire debt will be virtually extinguished. It would be deplorable in the extreme if such gigantic issues as we have in contemplation were to be made with the simple prospect of refunding the loans at some future time, particularly, in view of the strength of our present economic position. A perpetual debt or even a long debt must be avoided.

4. Finally, the question of the exemption from taxation must be considered. The argument in favor of exempting loans from taxation is that they will sell at a higher price and thus net the government a larger sum. While this argument is of great weight in times when the credit of the government is seriously impaired, at a time like the present, it has little force. Moreover, the argument on the other side is far stronger. If, as seems entirely likely, a large part of the necessary revenue will have to be raised by a greatly enhanced income tax, it is the height of injustice to divide the population into two classes and

to exempt from burdens the holders of government bonds. From the point of view of equality of taxation, there is no warrant for this. On the contrary, the investors in government bonds, like investors in all other forms of capital, enjoy what is called in the English tax an unearned income, and virtually everywhere in Europe an unearned income is taxed at a higher rate than an earned income. In this country, however, we should be adopting a double injustice: we should not be taxing the owners of bonds at a higher rate than the recipients of earned incomes, but we should as a matter of fact be taxing them at a lower rate.

Another argument often advanced is that it makes practically no difference whether or not bonds are tax-free. For if the purchaser of a government bond knows that he is to be exempt from taxation, this exemption will be capitalized into a difference in the selling price, and he will pay so much more for the bond or—what is equivalent to the same thing—will receive so much less interest. This assumes, however, that it is known in advance what the rate of the income tax is going to be. But in the present situation that is manifestly impossible. The subscribers for our proposed government bonds will, at a given rate of interest, pay a price which is calculated on the exemption from the present income tax and from an estimated future income tax. But what the increase in the income tax will be in the future no one can tell, and it is obvious that this unknown increase of the tax cannot be accurately capitalized. Therefore,

to the extent at least of any future unexpected increase in the income tax, the holders of bonds will enjoy an unmerited exemption. They will not be sharing the burdens with the rest of the citizens. Instead of paying a higher tax on the unearned income, they will be paying a lower tax.

Moreover, to exempt the bonds from taxation will cause injustice in yet another fashion. Our income tax is now highly progressive, and in the new income tax the progression may be made even more pronounced. The bonds, if issued as proposed in the present bill, are exempt in the hands of the holder whether he be a man with an income of five thousand or five million dollars. It can easily be seen that the exemption provision will have the practical effect of nullifying to a considerable extent the progressive rate of the income tax. The newspapers report that the new issue will be a 'rich man's loan' because of the eagerness of the payers of the super-tax to insure themselves against the probable increases in taxation. If the entire issue were taken by the tax-payers who fall in the highest super-tax group, if there were among them entire freedom of competition in subscribing for the loan, and if there were definite knowledge of what the future would bring in the way of increased income tax rates—then, and then only, would the exemption of the bonds from taxation have any basis in justice. These conditions, of course, cannot be met.

The lessons of the recent English loan are very significant. We are told that, of the entire issue of about £1,000,000,000, only an insignificant fraction

was subscribed for in the four per cent. tax-free bonds and that almost the entire sum was subscribed for in the five per cent. bonds, not free from taxation. This shows that the English investors prefer to take their chance of a future reduction of the income tax from the present high level. But it shows above all that England is on the right track in putting its loan virtually in the shape of bonds that are not exempt from taxation. The bondholder takes his chances equally with the rest of the community.

The American practice of issuing tax-free government bonds dates from a time when equality of taxation was not considered the controlling consideration. In the half century since the Civil War, great progress has been made in the realization of this conception, and almost uniformly abroad the tax-free provision has been eliminated from government issues. It is high time that this should be done also in this country. The present bill, unfortunately, makes only a slight concession to this demand. It makes the new government bonds liable to the estate tax. But the logic of this exception would impel to the total abandonment of the entire tax-free clause. In its present form the provision is both illogical and unjust.

III. TAXATION

According to our calculations, $1,500,000,000 of additional revenue will have to be raised this year, and some $3,000,000,000 the following year if we are to do our full share in the war, and at the same time to avoid shifting the burden too far into the future.

The reasons for heavy levies of taxes are clear. In the first place, it is always easier to impose severe burdens upon a community at a time when feelings of loyalty are aroused. Sacrifices are then made willingly which in ordinary times would cause much complaint. The capitalization of patriotism in this fashion for the accomplishment of national tasks is the height of financial wisdom.

The actual burden of taxes, moreover, in time of war is less than it appears to be. Not only are immense profits secured by the war contracts apt to be more or less diffused throughout the community in the shape of high wages and a great demand for materials, but, in addition, the higher level of prices which usually accompanies war makes a given tax a much smaller actual proportion of consuming power than under ordinary circumstances.

Finally, from the general economic point of view, it is far better to levy high taxes during a war, when the social income is great, and the diversion of income to ordinary investment of capital relatively small, than to postpone the taxes necessary to sink the debt until after the war, when the need of capital investment will again become acute.

From every point of view, therefore, as much money as is consistent with sound economic progress ought to be raised by taxation during the war, and, according to our analysis, it is very desirable to secure as much as $1,500,000,000 this year and $3,000,000,000 the following year. But how are such gigantic sums

to be brought into the treasury? What are the possible sources of revenue?

In former wars, both in Europe and in America, when the accumulation of wealth was comparatively small, and when the ideas of equality of taxation had not yet permeated the popular mind, it was possible to elaborate a system of taxation which, to a great extent, perpetuated the traditional system. This traditional system burdened primarily the consumption of the community and exempted its productive wealth. With the progress of democratic conceptions in taxation, all this has been changed. Of late, more and more stress has come to be laid on the idea of income and property and less on the criterion of expenditure. If we look at the practical possibilities of our American system, in the light of recent European experience, we shall see that there are only five possible sources of war taxation, each of which will be considered in turn.

1. The Property Tax

The attempt to raise any large sum by the taxation of property as such may be eliminated from consideration. For familiar reasons, which need not be recounted here, the general property tax has everywhere broken down in our state and local finance. It has become, in large part, a tax on of real estate, whereas what is needed at the present time is primarily a taxation of personal property and especially of intangible wealth. We have no taxing machinery in the federal government and it would probably be

impossible to devise any machinery which would make a property tax an administrative success. The only one of the warring countries which has made the attempt to levy a large property tax is Germany where, for special reasons, a workable scheme of assessing property values has been elaborated in the course of the last few decades. Even in England it has not been attempted. In the United States this whole plan may, for the immediate future at least be dismissed as impracticable.

2. *The Inheritance Tax*

The present estate tax as modified by the legislation of a few weeks ago, is calculated to produce $100,000,000. It is a tax at progressive rates, graded from one to fifteen per cent. The English system of death duties, with rates considerably higher and with a far lower limit of exemption, produces about $150,000,000 a year. There is no doubt that we could also secure a considerable augmentation of the yield by lowering the present exemption of $50,000. But in contemplating a great increase in the progressive scale of the estate tax, it would be necessary to remember that there are also state taxes on inheritances, the rates of which in some cases run up to fifteen per cent. At present, therefore, in parts of this country, we already have a system of inheritance taxes up to thirty per cent., a scale which is appreciably higher than anything existing in the great European countries. Any attempt considerably to increase the rates of the inheritance tax would have to be attended by at least

two modifications. In the first place, there would have to be some sort of accommodation between state and federal taxation of inheritances, with a provision that those states which derive a large revenue from this source should be compensated in some way. In the second place, if the rates were to be made very much higher than at present, it would be necessary to introduce the system now in vogue in some other countries, guaranteeing against a repeated payment of the tax on the same estate within a few years, if by chance the existing successive owners should die within a short period of each other.

Taking all these facts into consideration, it is not likely that any practicable change in the inheritance tax, even though it involved both an increase of the graduated scale and a decrease of the exemption, would net more than one hundred million dollars of additional revenue.

3. *The Income Tax*

The federal income tax this coming year is expected to yield about $250,000,000, approximately the same amount that Great Britain raised through her income tax before the war. The income tax in Great Britain is expected to yield this year about $1,000,000,000, that is, about $750,000,000 more than before the war. The question then arises: Can we not do the same? In what way could we also, possibly, quadruple the revenue from our income tax? This is an interesting but difficult field of inquiry.

It is undoubtedly true that our social income is

very much larger than that of England. Before the war, the English wealth was roughly estimated at about \$80,000,000,000, the German wealth at about \$85,000,000,000, and our wealth at about \$200,000,000,000 (the official figures for 1912 were \$187,000,000,000). All such estimates are indeed of the vaguest possible character. But taking them for what they are worth, it would follow that the income of the United States would be about two and one-half times that of Great Britain, making no allowance for a possible higher percentage of expected as compared with realized income in the United States. If, therefore, we had the same rates of the income tax as in England, it might be claimed that our revenue ought to be two and one-half times as great. Two important facts, however, must be remembered. In the first place, the exemption from the income tax in England is £130 or \$650, whereas, our exemption from the income tax is virtually \$4,000. Far more significant than this, however, is the fact that in an industrial country like England the great mass of the total incomes is derived from industry and trade, and that even the incomes from land are paid in great part by the large landowners. In the United States, however, the great mass of incomes arise from agriculture and are small in amount. Of all incomes, small farmers' incomes are proverbially the most refractory. In the statistics of the Wisconsin income tax published by the state tax commission, it appears that in 1916 the farmer paid only 3.86% of the state income tax, as over against 20.30% paid by manufacturers and 27.23%

paid by merchants and bankers. If Wisconsin may be taken as a fairly typical state, it is obvious that an immense deduction from the taxable income must be made for the agricultural incomes of the United States. It would not be at all safe to argue from British to American conditions.

It is important, however, to raise the question as to how much additional income tax could be secured by a considerable reduction of the exemption. Here again a surprise awaits us. Of the total income tax in the year 1914–1915, amounting to some $124,000,000, the proportions raised were, in round numbers, as follows:

Corporation tax	$56,994,000
Individual Tax:	
Normal tax	23,996,000
Additional tax	43,684,000

In other words, the additional tax was almost twice as large as the normal tax.

The additional tax was subdivided into the following categories:

Incomes from $20,000 to $100,000	$13,706,000
Incomes from $100,000 to $500,000	17,330,000
Incomes over $500,000	12,648,000

The Wisconsin tax statistics show that the tax-payers with incomes up to $4000 paid a tax of $517,520 out of a total tax on all individuals of $1,601,213. That is to say, with an income-tax exemption of only $800,[1] about one-third of the tax was paid by recipients of

[1] $1200 for man and wife.

incomes under $4000. It is manifestly out of the question, however, to assume that the federal exemption will be reduced to as low as $800. If we take $1500 as the lowest probable figure of exemption from the federal income tax, we find that, to judge from the Wisconsin figures, we should be adding only about sixteen per cent. or one-sixth to the receipts from the income tax. In England, on the other hand, the proportion of taxes paid by the relatively lower incomes in certain schedules is considerably greater. In 1914, these were the figures for the taxable income of certain tax payers in schedules D and E which include the ordinary commercial and industrial incomes.

Income	*Gross Taxable Income*
Below £300	£49,112,279
£300 to £600	25,421,620
£600 to £800	6,309,844
Total	£80,843,743
All incomes	£115,363,615

In other words, in these particular schedules, over two-thirds of the taxable income was found in the case of individuals with an income under £800 or $4000. £800 in England, however, probably means relatively more than $4000 in the United States. The above figures apply, moreover, only to partial incomes in a particular category. It is entirely probable, therefore, that the additional revenue to be expected by a reduction of the exemption would be very much closer to the one-sixth, as represented by

the Wisconsin figures, than to the two-thirds, represented by the English figures. Thus, for every one per cent. of income tax, which, as we have seen, meant about $24,000,000 last year, it would not be safe to add more than a third for the additional revenue to be secured by the reduction of the exemption to $1500. In other words, for every one per cent. of income tax, the normal tax would represent about $32,000,000, instead of $24,000,000.

The English income tax is now levied at a rate of from about twelve per cent. to a rate amounting to about thirty-four per cent. on the highest incomes. If our normal rate were to be ten per cent., instead of the existing rate of two per cent., the revenue from the normal tax on individuals would be about $240,000,000, if we kept the present exemption (ten times the yield of last year at one per cent.), or some $320,000,000 with a reduction of the exemption to $1500. As against the fifty millions awaited this year from the two-per cent. normal tax, this would mean an additional revenue of some $250,000,000. However, if the same rate of ten per cent. were applied to the corporation tax, we should get another $500,000,000. The additional tax still remains as a resource. With the rates running up to six per cent. last year, it yielded $43,000,000; yet the total estimated revenue of the income tax for the present year, with a normal tax double the year before, and with an additional tax running up to thirteen per cent., is expected to be only about twice as great. In order, therefore, to secure any very large revenue from the additional

tax, the rates would have to be increased considerably above the present figures. In order to secure \$200,000,000 or \$300,000,000 from the additional tax, the rates of the additional tax would have to run up to thirty-five or forty per cent., which, added to the normal tax of ten per cent., would mean a rate of some fifty per cent. on the highest incomes.

It follows, therefore, that if we try to secure an additional revenue of \$1,000,000,000 from the income tax, it would be necessary to reduce the exemption to \$1500, to make the normal rate about ten per cent. and to graduate the additional rate up to forty per cent. (or a total of fifty per cent.). This is very much higher than what exists in England at the present time, and probably fully as high as could be well endured. Moreover, with such rates, it would be imperative to make a distinction, as the European countries do, between earned and unearned incomes, taxing the unearned incomes at a lower rate. This would considerably reduce the revenue from the tax. Finally, another notable diminution of the yield would follow the unfortunate exemption of interest on the new gigantic war debt. With every billion of new tax-free debt, there would be a reduction of from ten to twenty millions in the yield of the income tax.

The general conclusion, therefore, is that it would be practicable to secure an additional revenue of perhaps \$750,000,000 from the income tax by a system which would grade the tax from about ten per cent. on moderate incomes up to forty per cent. on the

highest incomes, and with a proportionate reduction of the rate on lower incomes down to $1500. But the adoption of such an extremely high income tax would call for the greatest care in recasting certain features of the law which even now, with a low rate, are producing inequality and discontent.

4. *Excess-profits Tax*

Since the inheritance tax will yield comparatively little, and since the income tax can be counted on for only $750,000,000 of additional revenue, recourse should be made to a method that has been employed in Canada, Australia and almost everywhere in Europe and which is already being used to a certain extent in the United States, *viz.*, the taxation of excess profits. Last September, Congress passed an act, placing a levy of twelve and one-half per cent. on the net profits of munition manufacturers.[1] Only a few weeks ago, there was added to this a small tax on excess profits in general.

Much might be said, in this connection, concerning the desirability of government action in the direction of price control, particularly the control of the prices of war materials. The enormous purchases soon to be made, will be a disturbing element in the market situation—one which will destroy many of the ordinary safeguards of free competition. Price regulation, which would effectively restrict prices to a point near the cost of production, would be preferable to high

[1] In the case of the munition manufacturers' tax, the levy is made against all net profits without the eight per cent. allowance.

prices, high profits and a high excess-profits tax. Price regulation would mean a diminution, of course, in the fiscal results of the excess-profits tax.

There is a great and important difference between the European taxes and our own excess-profits tax. All of the European laws measure taxable profits by comparing present profits with the average profits of business before the war began; in some cases this average is taken for a number of years. Our law, however, takes the arbitrary figure of eight per cent. on the "capital invested" (plus $5000)[1] as the normal profit and taxes everything above that eight per cent.

This arbitrary method is unfair both to investors and to industry. Especially in a comparatively new country like the United States, where risks are great and losses frequent, a profit of more than eight per cent. is often necessary to justify investment. At the present rate, the situation is not serious; but with the necessity of levying a far higher rate, the continuance of our present method would involve us in difficulties. At a period like the present, it is of the first importance not to put a check upon business enterprise or to cripple the desire of individuals to do their utmost in the way of productive capacity. The principle of taxing very heavily excess profits above normal peace profits is indeed defensible; but to penalize all profits above eight per cent. applied to a base such as that prescribed in our present law can

[1] "Capital invested" is defined to include cash paid in, the cash value at the time of payment of capital represented by property and surplus invested in the business.

scarcely be upheld. Instead of bringing any more revenue, a larger rate upon such excess profits might yield actually less revenue, in addition to placing an unfair burden upon a particular class of investors. It cannot be emphasized too strongly, therefore, that if we are to have a high excess-profits tax, we should follow the European principle and abandon the arbitrary methods now being followed.

The yield of the present law is problematical, but it has been roughly calculated that the returns will be between \$200,000,000 and \$225,000,000. A very vague estimate, made some time ago, figured that the excess profits last year were about \$5,500,000,000, but that the deductions and exemptions in the law reduced the taxable excess-profits to some \$3,000,000. In Great Britain, the excess-profits tax was estimated to yield in the fiscal year just ended between \$400,000,000 and \$500,000,000. But it will probably yield between \$600,000,000 and \$700,000,000. The English tax is levied at the rate of sixty per cent. While our excess profits have been exceedingly great, it is doubtful whether they have been much larger than in England where the profits have come not only from the war expenditures, but also from the immensely enhanced returns from shipping. In order to secure \$500,000,000 more from the excess-profits tax in this country, it would be necessary, assuming that the suggested changes be made in the base line from which to measure the excess of profits, to increase the rate to forty or fifty per cent. It might be advisable to take as a basis, not only the profits of the current

year, but the average of the excess profits of the last two or three years, in which case the yield would be largely increased.

5. *Indirect Taxes*

If the rates of the income tax and of the excess-profits tax were raised to the height suggested during the first year, sufficient revenue might be obtained for the needs of that year without other taxes. It is possible, of course, that much more might be obtained than has been estimated. At any rate, valuable experience would be gathered and a more definite basis for future calculations would be made available. If the machinery of direct taxation appeared to be in no danger of breaking down it might be possible even to make further increases in rates. If, on the contrary, the yield of the first year's taxes was disappointing, or if it seemed wise not to raise the rates to the suggested maximum at once, there would still remain the whole field of indirect taxation.

It is perhaps significant that all of the warring countries have found direct taxation alone to be insufficient. In Germany, where immense additions have been made by the localities and the separate states to the income taxes, the federal government has imposed large burdens, not only on excess profits, but also through indirect taxes. The same is true to a still greater extent in France. In England also, the revenue from indirect taxes, and especially from customs and excise, has been very largely increased as appears from the following figures:

Tax	*1914*	*1916*
Customs	£35,569,000	£57,707,000
Excise	39,658,000	61,210,000

The figures for 1917 show a still further increase. In other words, England has secured an additional revenue of about $250,000,000 from the customs and excise duties alone, having imposed higher taxes on tea, sugar, coffee, railway tickets, and a variety of other items. In the United States, our revenue from the tariff is about $100,000,000 less than the British revenue from her free-trade tariff.

Our Civil War experience indicates the rich productivity of indirect taxation. If we were to tax certain articles at the rates customary in the Civil War, it would be easy to secure an immensely enhanced revenue. From calculations which were printed in a detailed table appended to the recent report of the Committee on the Relations of State and Federal Taxation, submitted in January to the Seventh Annual New York State Conference on Taxation, it appears that the revenue from certain taxes on commodities, if levied at Civil War rates, would be, during the coming year, about as follows:

Source	*Estimated Revenue in 1917*
Tobacco	$305,000,000
Distilled spirits	272,000,000
Petroleum	282,000,000
Cotton	120,000,000
Iron and steel manufactures	122,000,000
Cotton goods	53,000,000
Woolen goods	36,000,000
Boots and shoes	44,000,000

Source	*Estimated Revenue in 1917*
Coal	31,000,000
Railroad passenger tickets	82,000,000
Leather	26,000,000

This list could be extended almost indefinitely.

Moreover, it may be recalled that in 1916 some $42,000,000 was raised in the United States by stamp taxes. This source yielded England about $35,000,000 last year. Probably as much as $75,000,000 could be collected by such a tax without making the rates exorbitantly high.

While it is obvious that it would be unwise to levy all or even a large proportion of these taxes, it is clear that certain commodities might be chosen and that the tax might be so graduated as to fall primarily on the better qualities of the goods rather than on the necessities.

In any event, it would be comparatively easy to raise a few hundred million dollars from such indirect sources. This system, as a supplement to the vastly more important direct taxes, would probably suffice for the first year or two of the war. Were the war to continue for a longer period, it would be necessary, of course, to revise all our calculations.

In conclusion, it may be pointed out that since this war is being prosecuted on a gigantic scale, our expenditures and our revenues must be expected to be on the same scale. All previous ideas on the subject must be thrown in the scrap heap, together with the similar views as to the military conduct of the war. Of one thing, however, we may be assured.

The prodigious wealth and the unexampled prosperity of the United States ought to leave no doubt as to our ability, not only to finance the war, but to finance it successfully and equitably. But in the utilization of our enormous resources, it becomes all the more important to develop a system which will conform to sound economic principles and which will be in harmony with modern ideas of equality and justice.

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